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On Taxes and Foreign Investment, Flaherty's Aim is Off

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Federal Finance Minister Jim Flaherty's March 19 budget included important — and unexpected — proposals that would dramatically reshape income tax rules affecting foreign investment by Canadian corporations. The budget's proposal to withdraw tax deductibility for interest expenses incurred to finance investments in foreign affiliates is momentous. It could affect Canadian businesses' ability to participate in the global economy and even to remain competitive in home markets.

While reshaped Canadian rules for international taxation are overdue, the government's present proposals require further thought. Inattention to transition issues, grandfathering rules, and the need for Canada to lower the statutory general corporation tax rate are part of the problem with the proposals. What is more important is that such potential reforms need to be placed in a broader international context.

Canada's system for the taxation of international income flows has been in place for over 30 years. On the general assumption that income earned abroad is already taxed abroad, the system exempts from Canadian tax almost all of the dividends from the foreign affiliates of Canadian parent companies, while allowing them to deduct in Canada the interest expense incurred to finance foreign holdings.

During the last 30 years, however, there has been an explosion in the size and complexity of international trade, finance and investment. Multinationals now more commonly steer capital finance through low-tax jurisdictions and pursue other advanced international tax strategies, giving rise to concerns around the world about threats to national tax revenues and even the continued viability of the corporate income tax. Canada has played its part in these changes: Canadian direct investment abroad now exceeds foreign direct investment here, and Canadians' income from foreign direct investment has more than doubled in the past four years, to $30 billion and rising.

"Double-Dipping" Concerns: Minister Flaherty has professed concern about foreign multinationals' use of tax planning devices, including the infamous "double dip," whereby a parent company obtains two (or more) deductions for its interest expense incurred to hold its foreign investments. The parent, for example, borrows at home and deducts the interest expense domestically, then uses the funds to invest in the shares of an affiliate based in a low-tax jurisdiction, whose income can be repatriated as a tax-free dividend to Canada. The tax-haven affiliate, in turn, advances the funds as a loan to an operating corporation (in a third, high-tax country) which then also deducts the interest.

The rules that encourage these practices distort international investment flows, because they can make it preferable for a domestic corporation to pursue a foreign investment, owing to higher after-tax returns, rather than an otherwise equivalent domestic investment. This is an economic inefficiency, and one facilitated by the variety of international tax systems and the range of rates among them. This means Canada should indeed take another look at our rules for taxing international income flows.

Some Positives: In fact, some of the tax changes proposed in the March budget should be positive for Canada. With some short delay, the government proposes to eliminate withholding tax on interest payments to US lenders and presumably, in due course, to other countries that have a tax treaty with Canada, improving Canadians' access to international financing and lowering their cost of capital. Canadian companies' ability to bring back tax-free dividends from abroad is even to be slightly enhanced.

The big change, however, is the proposal to disallow the deduction of interest that Canadian companies pay on borrowings to finance equity and debt investments in their foreign affiliates, except to the extent that it offsets taxable dividends and interest received from them. As most dividends from affiliates abroad are exempt from Canadian tax, the deduction for interest costs will be unusable in most cases.

The government's stated intent is to protect the Canadian tax base by disallowing deductions for interest expenses that are not associated with Canadian taxable income. It may prove not to be a significant direct revenue-raiser, because no company will pay non-deductible interest if it can possibly avoid doing so. But — depending on the fine print of the new rules — it will cost Canadian businesses to rearrange their debt, and could have a profound effect on the structure and cost competitiveness of Canadian business.

Unexpected Impacts: Businesses will respond quickly, and in many ways, such as by borrowing abroad to finance offshore investments, thus indirectly expanding the Canadian tax base. Businesses will also seek to trace new investment in foreign operations back to Canadian equity or non-borrowed retained earnings, while increasing their domestic operations' leverage. (Rules on tracing are difficult to enforce, and difficult to comply with; for many firms, it will not be easy to match past borrowings with current investment in affiliates.) Further, foreign-owned multinationals will be a little less likely to deduct international interest expenses from income booked by their Canadian subsidiaries. Yes, the new provisions will go some way to protect the Canadian tax base; inevitably they will also complicate

and in some cases impair the willingness and ability of Canadian corporations to make new foreign investments.

Even if the long-term direct impact on Canadian businesses' tax liability does not turn out to be large, the enduring effects on Canadian businesses' global structure gives reason for taking a cautious look at the government's proposed route. For instance, by investing in business operations abroad, Canadian corporations create markets for Canadian goods and services, and can achieve the necessary size to fund world-scale research, development and marketing, as well as financing and operating economies. And there is new evidence that when Canadian companies flow their investments through low-tax jurisdictions to other offshore markets, Canadian trade with those markets grows.

The proposed provisions would make it harder for foreign multinationals to transfer interest deductions for their other foreign investments into Canada. But a better approach might be to reduce Canadian tax rates — thus cutting the payback on such planning — and developing more effective "thin cap" rules, or thresholds for the ratio of debt to equity in investments in Canadian operations above which interest costs would not be deductible. Making it harder for highly leveraged businesses to deduct interest costs against Canadian profits is precisely what "thin cap" is about — yet Canada's rules on this front are lax.

Further, as the international tax system moves toward a model where interest costs associated with outbound investment are harder to deduct against taxable income — the UK is currently proposing changes which could bring its system closer to the proposed Canadian regime — the need to reduce statutory tax rates becomes paramount. This is exactly what the March budget failed to address.

Accordingly, the proposed Canadian tax system could place Canadian companies at a significant disadvantage, both abroad and even in Canada, in competing with their foreign counterparts. The government's understandable desire to introduce more "fairness" and stem erosion of the Canadian tax base therefore needs to be matched by significant statutory rate reductions in the interest of economic competitiveness.

Tax changes relating to fundamental aspects of our domestic and international business need to be thought through as a package, rather than one provision at a time. The proposed disallowance of interest on loans to finance foreign investment needs to be considered in the light of our overall tax strategy for a dynamic and internationally competitive Canadian economy. Introducing the non-deductibility of interest without thinking through the need for Canada to have lower and internationally competitive rates would be a major mistake.

What is Fair? Fairness and equity are not easy things to discover in international tax, where tax rates and rules differ enormously from country to country. There is an inevitable tension between neutrality in determining tax burdens on foreign income and the deductibility of foreign costs, on the one hand, and the desire to reap the benefits of having a vibrant and growing group of Canadian multinationals operating around the globe, on the other.

Beyond this, the recent budget proposals do not concentrate enough on tax distortions that encourage "debt-dumping" into Canada. The changes instead introduce a radical restructuring of long-established tax policy without allowing appropriate input from those affected and the public. Now, the Finance Minister has proposed a panel to review the system in advance of the 2008 budget. That

would be appropriate. Canada needs a fuller consideration of policy toward taxing international income, focussed on the not-necessarily compatible objectives of supporting Canadian economic activity and preserving the Canadian tax base.

This *e-brief* is a publication of the C.D. Howe Institute. **Robert D. Brown** chairs the Institute's Tax Competitiveness Council and was a member of the Technical Committee on Business Taxation.

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